B. Wholesale Rates Must Recognize The Difference Between Large and Rural Telephone Companies.

Essential for meeting the obligation of the carrier of last resort is the flow of access charge revenues to the incumbent LEC in order to support the infrastructure that provides universal service. Access charge flows need to be considered when discussing pricing. Undoubtedly, access charges must continue to flow to the LEC which maintains and owns the facilities. Since a retail price includes access support to the incumbent LEC, the retail rate is actually less than cost. It would make no sense for a new entrant to benefit twice from access support by purchasing an element at a below cost retail or wholesale rate and then collecting access compensation for this purchase, essentially doubling the support amount. The RTC agrees with the Commission's conclusion that "an entrant that merely resells a bundled retail service would not receive the access revenues"[24] since this wholesale rate was derived from a retail rate that included access support. Consequently, unbundled element pricing must include access considerations and therefore cannot be priced at less than cost using an "imputation" rule. Additionally, as the Commission states, "if unbundled elements were priced at less than cost, then efficient facility-based entry would be deterred, as new entrants purchase unbundled network elements at below cost rather than constructing their own facilities."[25]

The RTC encourages the Commission to consider not only access revenue flows when discussing retail and wholesale rates, but also the unique economics of small, independent LECs when it comes to "avoided costs." Avoided costs, as defined by the Act, are "attributable to any

---

[24] *NPRM* at ¶ 186.

[25] *NPRM at ¶ 186.*

marketing, billing, and other costs that will be avoided by the local exchange carrier."[26] The scope of net avoided costs for larger urban LECs will naturally be higher than such costs for isolated rural LECs. Obviously, marketing costs for a LEC with minimal or no competition are much lower than those of an urban LEC dealing with a multitude of competitors. On the other hand, due to the small size of rural LECs' staffs,[27] general overhead costs will be higher. The resources/employees needed for overhead costs in a large LEC can be handled by a few employees out of a pool of hundreds, whereas these costs are incurred by one employee out of a handful in a small company. Therefore, the amount of "avoidable" overhead cost for a small LEC is substantially smaller than the avoidable overhead cost for a large LEC. Accordingly, the Commission should avoid establishing "a uniform set of presumptions"[28] since there is no uniformity between the cost structures of large and small LECs. Attempting to "identify specific accounts or portions of accounts"[29] as avoided costs is also fraught with inconsistencies due to the extreme variations between large and small LECs.

Rules developed to foster competition with large urban LECs in mind could be devastating if applied to small rural situations. The RTC urges the Commission to consider the diversity of individual LEC economies before it mandates across-the-board pricing standards.

---

[26] Section 252(d)(3) of the Act.

[27] Over half of the members in NECA's traffic sensitive pool operate with less than ten employees.

[28] *NPRM* at ¶ 181.

[29] *NPRM* at ¶ 181.

C. Proxy Models Have Not Yet Been Proven Adequate.

To date, there are no adequate proxy models or surrogates for cost-based rates that could be used to set rate ceilings for interconnection. While proxy models such as the BCM have been examined for universal service purposes, so far no entity has introduced a proxy to deal with the intricacies of interconnection and its related unbundled network elements and "geographically divergent factors such as population density."[30] So far, the Commission is proposing only theoretical proxy ideas for rate ceilings. Specific, interconnection-oriented models that consider LRIC theory, historical costs, and common costs do not exist. Until a model can be proven to adequately correlate to the unique characteristics of rural areas, a proxy model is not a viable option.

The Commission asks if the BCM would be adequate "as an appropriate proxy."[31] The efficacy of the BCM for the purposes of identifying high cost areas for universal service purposes is still suspect. In fact, as US West states, "[the BCM] will be modified in the future to incorporate certain enhancements that will allow for even better targeting."[32] At this time, especially for rural areas, the BCM has been shown to create severe anomalies in the identification of high cost areas. To adopt its use for the purposes of interconnection pricing could lead to cases of inaccurate and confiscatory pricing. The BCM is not even ready to be used for its original purpose of targeting high cost areas, much less for the purpose of determining rate ceilings for

---

[30] *NPRM* at ¶ 137.

[31] *NPRM* at ¶ 137.

[32] US West reply comments in CC Docket 96-45 at p. 22.

interconnection. Until a sufficient proxy model is proposed and scrutinized for interconnection pricing, the Commission should adhere to a cost-based pricing of network elements.

D. Bill and Keep Should Not Be Prescribed As Reciprocal Compensation.

The RTC believes that reciprocal compensation for the transport and termination of local calls should be based upon mutual compensation and good faith negotiations, consistent with the intent of the Act. There is no overwhelming reason why the Commission should establish generic pricing arrangements for the transport and termination of local traffic. Proposals such as bill and keep and symmetry do not consider the costs involved in the use of another carrier's network. As the Commission itself states, "bill and keep arrangements would not provide for the 'mutual and reciprocal recovery by each carrier of costs associated with the transport and termination on each carrier's network facilities of calls that originate on the network facilities of the other carrier,' which would violate the requirement of Section 252(d)(2)(A)(I)." Obviously, proposals that fail to adequately deal with each carrier's costs such as bill and keep should not even be considered, even as an interim proposal.

E. The Commission Should Not Adopt Pricing Approaches That Would Deny LECs the Ability to Recover Their Costs.

In its *NPRM*, the Commission relies on the statutory language in section 251(c), requiring incumbent LECs to provide interconnection and unbundled network elements "on rates, terms, and conditions that are just, reasonable, and nondiscriminatory" as the basis for its authority to adopt pricing principles that would apply on a nationwide basis.[33] The Commission solicits comment on the proper interpretation of the requirement of "just and reasonable rates" for

---

[33] *NPRM* at ¶ 121

unbundled elements and collocation in this section of the Act, and in Section 252(d)(1) whch states that the just and reasonable rate:

> (A) shall be (I) based on cost (determined without reference to a rate-of-return or other rate-based proceeding) . . ., and (ii) nondiscriminatory, and (B) may include a reasonable profit.[34]

The RTC does not agree that these provisions of the Act give the Commission authority to establish national pricing principles.[35] The Commission tentatively concludes that Sections 251© and 252(d) preclude states from using traditional cost-of-service regulation to set rates, and instead suggests the use of other cost-based price regulation mechanisms, including the setting of prices based on a forward-looking cost methodology that may not involve consideration of an embedded rate base, such as with a long-run incremental cost (LRIC) method.[36] The promulgation of national rules would be an imposition on the ability of providers to negotiate efficiently, and on the states' rights to effectively oversee competitive pricing mechanisms, without sufficient consideration of differences in "efficient" pricing from one area to the next. The RTC will nonetheless discuss the pricing proposals in the *NPRM*.

With regard to the use of a forward-looking cost methodology, the Commission touts the benefits of pricing at the margin, and states that most "appear to agree that rates for interconnection and unbundled elements ideally should be based on a TSLRIC-type methodology."[37] Hence

---

[34] *See* Part I, *supra.*

[35] *See* Part I, *supra.*

[36] *NPRM* at ¶ 123.

[37] *NPRM* at ¶ 126.

the Commission concludes there is a consensus that some use of marginal-cost pricing is preferable from the standpoint of economic efficiency While it is true that an incremental cost approach may provide one useful, theoretical tool by which to formulate pricing policy, most economists also concur that this standard should be used for guidance only, and must be further accommodated with additional factors and considerations. Marginal costs decline continually with output when any sort of economies of scale are present. If rates are set equal to the cost of that last unit, total revenues are sure to fall short of total costs.[38]

Incremental cost analysis cannot alone determine costing and pricing rules.[39] To use the theory of LRIC pricing as the sole measure by which to judge just and reasonable rates and to ensure that the goals of nondiscrimination and reasonable profit are met would certainly be erroneous. To require that rates be set directly equal to short-run marginal cost for an interim time period,[40] allowing no freedom to consider network expansion or other necessary factors, would be an even more drastic and inappropriate measure

---

[38] *See* John T. Wenders, *The Economics of Telecommunications: Theory and Policy,* (Ballinger Publishing Company, 1987) at 22-41

[39] In any event, incremental cost analysis only divulges the <u>minimum</u> point of a range of prices across which the most efficient price exists. In a competitive environment, economists agree that the marginal cost merely provides a floor above which providers will price. "To avoid the possibility that prices for the competitive services might be set too low, the cap should be accompanied by a lower bound of pricing flexibility, set, as a first approximation at incremental cost plus the contribution element charged to competitors in the interconnection price." *See* Affidavit of Alfred E. Kahn, CC Docket No. 19-141, February 28, 1993. *See also*, John T. Wenders at 67 and James C. Bonbright, Albert L. Danielsen, and David R. Kamerschen, *Principles of Public Utility Rates* (Public Utilities Reports, Inc., 1988) at 457.

[40] *NPRM* at ¶ 132.

In their discussion on incremental pricing in local telephony, Sibley and Weisman define a "level playing field" as a set of regulatory rules that ensures the least-cost provider is not precluded from being the least-price provider.[41] LECs with the incumbent burdens of universal service, rate averaging, and carrier-of-last resort obligations cannot set prices equal to marginal costs alone. The RTC stresses that if competitors were not subject to these same constraints and were to enjoy interconnection at an incremental-minimum price, thus able to set lower service rates, the least-cost provider may indeed be precluded from being the least-price provider. Hence, the social goal of a "level playing field" will *not* be achieved.[42] Similarly, the pro-competitive aim of the 1996 Act will be defeated since competition posits a "level playing field," and Congress did not intend to create winners and losers or favor one group over another.

The Commission has recognized that incremental pricing does not properly provide for recovery of the common costs of providing service, such as the cost of the local loop.[43] As a potential solution to this dilemma, the Commission suggests that the problems inherent in allocating common costs and other overheads may be dealt with by identifying a substantial portion of costs as incremental to a particular service or element.[44] Shared costs must be recoverable through rates. However, it is difficult to find a particular service for which common

---

[41] *See* David S. Sibley and Dennis Weisman, *The Competitive Incentives of Vertically Integrated Local Exchange Carriers: An Economic Policy Analysis* (1995).

[42] Id.

[43] *NPRM* at ¶ 144. *See also, Notice of Proposed Rulemaking*, CC Docket Nos. 95-185 and 94-54, released by the Commission on January 11, 1996, at paras. 49-55.

[44] *NPRM* at ¶ 130.

costs are incremental. In any event, shared and common costs should not be included in incremental rates for local service or assigned in a manner that negatively shifts these costs to other areas counter productive to universal service goals.[45]

The telecommunications industry may have a lesser need to address the part of the network that is jointly used if local exchange carriers under the new regulatory framework for interconnection and unbundled elements actually sell network components (i.e., loops or a pair of wires, switching capacity, etc.). If the formerly jointly, with respect to traditional service classifications, used components are replaced with a separate products approach, there will be fewer joint and common costs to recover. Hence, in this manner, each component would reflect its own costs, rather than allocating components of the network among services.

In any event, incumbent LECs bear substantial joint and common costs regardless of whether one is examining network components or traditional services. If a pure LRIC methodology is implemented, the common fixed costs will remain and must somehow be recovered. "To [rule] otherwise is to condemn the regulated firm to incur losses."[46] The Commission seeks comment on whether or not recognition of embedded costs in the short run should continue if an incremental cost standard is established. Recognition of embedded costs is essential, and

---

[45] This is consistent with the conclusion of the Washington Utilities and Transportation Commission ("WUTC") in a recent rate case of US West. "Since the loop is required if [US West] is to provide any one of toll service, access service, or local service, it is incremental to none of the services." *Fifteenth Supplemental Order*, Docket No. UT-950200, released by the WUTC on April 11, 1996 at p. 83.

[46] *See* William J. Baumol, *Toward Competition in Local Telephone* (MIT Press, 1994). NARUC agrees that network component prices should be permitted to include a markup over LRIC to reflect joint and common cost allocation. *NPRM* at n.174.

particularly necessary for high-cost, rural, sparsely populated areas in which the portion of costs not clearly addressed by incremental theory will most likely constitute a large percentage of the overall costs of recovery burden.

The Commission must also recognize that setting rates strictly equal to LRIC without recognizing embedded costs and other factors will provide LECs with no incentive to invest in network upgrades. This may then cause an inefficient degradation (and threat to universal service goals) leading to a cost of providing service that exceeds its minimum possible level. In designing regulatory policies to guide efficient rate structures, interconnection rates must provide sufficient incentive for the incumbent firm to undertake network investment.[47] To do differently is to encourage an inefficient result. Carriers cannot make capital commitments to major network upgrades and maintain current facilities if they are to be subjected to cost recovery based on a minimizing approach, as incremental costing would yield.

In but a brief summary of the principle, the Commission dismisses the "efficient component pricing rule" ("ECPR") proposed by economist William Baumol and others as an inappropriate method by which to base rates.[48] The Commission, without substantive discussion, tentatively concludes that under ECPR, the statutory language requiring that prices be "cost-based" would not be satisfied.[49] The *NPRM* discussion fails to recognize portions of Baumol's basic argument demonstrating that pertinent marginal cost must *include* all opportu-

---

[47] *See* David S. Sibley and Dennis L. Weisman.

[48] *NPRM* at ¶ 147.

[49] *Id.*

nity costs incurred by the provider. If the Commission concludes that incremental cost pricing is a "cost-based" method, then it must also allow for recognition of opportunity cost. Without including this markup over incremental costs, there is not full compensation.[50] Section 252(d)(1), which the Commission relies on to reject ECPR explicitly, provides that "the just and reasonable rate for network elements . . . may include a reasonable profit."

This leads to the discussion of other overlooked costs, perhaps also considered opportunity, that must be considered above mere incremental methods. The cost to recover capital not properly depreciated in the past, the cost on LECs imposed by the prohibition against exiting the market, the cost of asymmetrical regulation of existing LECs, the cost of serving as the last resort capacity guarantor, and the cost of maintaining and expanding universal service must also be addressed in pricing policy.

The Commission also tentatively concludes that under ECPR, competitive entry does not drive prices toward competitive levels.[51] However, Baumol argues that use of a stand-alone cost ceiling *in combination* with the ECPR pricing principle will produce the desired pricing efficiency.[52] If prices are set above the price floor but below the stand-alone cost cap, and the LEC is allowed the full benefit of any gains realized from a reduction in the marginal cost, the desired market incentives for cost-reducing innovation can be achieved.[53]

---

[50] *See* William J. Baumol at 102.

[51] *NPRM* at ¶ 147.

[52] *See* William J. Baumol at 108.

[53] *See* David S. Sibley and Dennis L. Weisman.

If the ECPR pricing rule is used correctly with a stand-alone cost ceiling, or for that matter, if any pricing mechanism is established with a cap of some sort and LRIC as a price floor, the result will be a legitimate "band" or range within which providers may set rates. Calculation of the perfectly correct, single "price" will require subjective analysis beyond the wisdom of regulation. Any type of price ceiling cannot be fixed and must evolve. Where intervention is necessary, the RTC maintains that responsibility should be left to the states. The additional factors which must be considered above a LRIC floor and below an appropriate stand-alone ceiling should not be decided according to a rigid, federally imposed standard. The states are in a better position to decide the specific options between the limits.

If, however, the Commission is to establish some national pricing and costing structure for interconnection, the RTC supports a transitionary period approach. And contrary to Commission's tentative conclusion, the RTC believes use of the ECPR pricing rule may be just as useful a tool for the interim as any of the other suggestions. Often it is not possible to see whether or not a single price has fallen short of the true incremental cost until it can be studied in retrospect. Use of a pricing rule that recognizes an appropriate range would allow the Commission to further study proper applications of LRIC and other approaches while preventing the application of pricing rules that will inherently harm LECs and consumer welfare. At the very least, the RTC urges the Commission to assure that there is some measure made available to LECs by which embedded costs may be recovered at least in the interim.

IV. TECHNICAL ISSUES ASSOCIATED WITH INTERCONNECTION.

The Commission asks for comment on a number of issues regarding technical and other conditional considerations for interconnection, the offering of any necessary unbundled network elements to competitive entrants, and collocation.[54] The discussion in the *NPRM* suggests partly that similarity in networks may also argue in favor of a standard approach to these issues for all incumbent LECs. The RTC concludes that many of the proposals may be overly rigid and may, in many cases, go beyond what is required by the law.

In the interest of time and space, the RTC will address these issues in this initial round in summary form below. The summary points are based on a more detailed discussion prepared by telecommunications engineers in the employ of GVNW, Inc.--Management ("GVNW"). The detailed comments which we reference here reflect the experience of GVNW in working with the smaller LECs. These comments, summarized below, are designed both to emphasize the different operating nature of smaller LECs and to reflect on several specific issues presented in the *NPRM*:

1. Rigid rules for interconnection and the unbundling of network elements should not be attempted because such an approach would be incapable of keeping up with changes in technology and would not accommodate differences among carriers operations.

2. Interconnection must not jeopardize network reliability. All carriers should have assurance that they are interconnecting with only "technically reliable" providers.

3. Interconnection and collocation "points" should also be set in a flexible manner to recognize real differences between small and large operations, high-volume and low-volume local networks, and urban and rural carriers and networks. These differences involve:

a. Digital switch size, type, and manufacturer.

b. Differences in the ability to subdivide the local loop, specifically with respect

[54] *NPRM* at ¶¶ 39-116.

to interconnection at intermediate, concentration points.

c. Space availability in buildings of different sizes.

d. Trunking capacity cost increments at different absolute values.

e. Degree of large computer network administration.

f. Personnel deployment.

g. Operations interfaces.

4. Carriers that unbundle will incur additional costs which must be recognized in the price. Interconnectors should be required to compensate LECs for any fixed cost required to allow them to interconnect. Interconnection costs can be limited for all by limiting interconnection to only bona fide requests. LECs must be protected from losses for costs incurred just to provide interconnection.

5. There should be minimum training and proficiency requirements for personnel of collocated carriers.

6. The unbundled network elements should be constructed in a manner such that the elements include those portions of the network between natural interconnection points. As such, a recommended set of natural interconnection points and corresponding unbundled network elements with a degree of needed flexibility is proposed in the GVNW comments.

7. Unbundling requirements should be limited for small and rural LECs to those instances where it is technically feasible, specifically needed by a competitor and economically feasible.

8. Service intervals for small and rural LECs with respect to provision of interconnection should only be equal to those which the LEC achieves for itself. Small LECs (or low volume

networks) should not be expected to bear the cost of high levels of spare network capacity just to meet speculative demands of interconnectors.

9. Unbundling cannot require the partitioning of switches because it is not technically feasible.

10. SS7 interconnections should occur only at "Gateway Screening" points.

11. SS7 interconnection must recognize the wide variation in the degree in which advanced intelligent network services have been deployed among different LECs in high-volume and low-volume applications, and high-demand and low-demand areas.

V. CONCLUSION.

The Rural Telephone Coalition comments have shown in detail that the tentative conclusion of the Commission's *NPRM* to provide detailed national regulations for implementation of new Sections 251 through 253 is inconsistent with the letter and spirit of the 1996 Telecommunications Act. The Act has a dual thrust: to encourage voluntary negotiation of interconnection agreements by competing local exchange carriers and to provide for state commission resolution where agreement is not reached. The Act contemplates limited, not expansive, regulation in a bold change in direction of federal-state relationships. The Commission need not fear that provision of maximum flexibility for states will impede the growth of competition; many states were well ahead of the 1996 Act, and the interconnection requirements of the Act are very specific and compelling. The Commission must reverse its slide into micro management and recognize that having multiple solutions to problems that have never been addressed in the modern age will lead most surely and quickly to workable solutions nationwide.

To the extent that the Commission nevertheless adopts pricing rules or guidelines, these rules must not be based on economic theories which would have the effect of denying local exchange carriers the opportunity to recover their costs, especially the costs they incurred under the previous paradigm. The various proposals for marginal-cost pricing do not adequately provide recovery of joint and common costs which must be recovered if the enterprise is to remain in business and providing service. The inevitable result of such plans is to leave the local basic service subscriber holding the bag, at rates which will necessarily violate the universal service prescriptions of new Section 254.

Finally, if the Commission nevertheless adopts rules governing unbundling and technical feasibility of interconnection, it must recognize that difference in situation, structure, vendors and operations preclude automatic application of rules suitable for urban environments and large LECs to Rural Telephone Companies.

Respectfully submitted,

THE RURAL TELEPHONE COALITION

NRTA	NTCA	OPASTCO
By: Margot Smiley Humphrey (DC)	By: David Cosson	By: Lisa M. Zaina (DC)
	By: L. Marie Guillory	By: Ken Johnson
	By: Steven E. Watkins	

Koteen & Naftalin, LLP 1150 Connecticut Ave., NW Suite 1000 Washington, D.C. 20036 (202) 467-5700	2626 Pennsylvania Ave. NW Washington, D.C 20037 (202) 298-2300	21 Dupont Circle, NW Suite 700 Washington, D.C. 20036 (202) 659-5990

May 16, 1996

CERTIFICATE OF SERVICE

I, Gail C. Malloy, certify that a copy of the foregoing Comments of the National Telephone Cooperative Association in CC Docket No. 96-98 was served on this 16th day of May 1996, by first-class, U.S. Mail, postage prepaid, to the following persons on the attached list:

Gail C. Malloy

Gail C. Malloy

Chairman Reed E. Hundt
Federal Communications Commission
1919 M Street, N.W., Room 814-0101
Washington, D.C. 20554

Commissioner James H. Quello
Federal Communications Commission
1919 M Street, N.W., Room 802-0106
Washington, D.C. 20554

Commissioner Rachelle B. Chong
Federal Communications Commission
1919 M Street, N.W., Room 844-0105
Washington, D.C. 20554

Commissioner Susan Ness
Federal Communications Commission
1919 M Street, N.W., Room 832-0104
Washington, D.C. 20554

Mr. Kent Nilsson, Chief
Network Service Division
Common Carrier Bureau
Federal Communications Commission
2000 L Street, N.W., Room 253
Washington, D.C. 20554

International Transcription Service
2100 M Street, N.W.
Suite 140
Washington, D.C. 20037

Ms. Janice Myles
Policy and Planning Division
Common Carrier Bureau
Federal Communications Commission
1919 M Street, N.W., Room 544-1600G
Washington, D.C. 20554